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STATE OF MONTANA

BOARD OF EQUALIZATION

REPORT ON COMPLIANCE PROCEDURES AND CONTROLS
AS A SUPPLEMENT TO OUR
REPORT ON EXAMINATION

Fiscal Year Ended June 30, 1968

MONTANA STATE
930 East Lincoln Avenue
Helena, Montana 59601



OFFICE OF THE LEGISLATIVE AUDITOR

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APPOINTIVE AND ADMINISTRATIVE OFFICIALS

STATE BOARD OF EQUALIZATION

Board Members

Howard H. Lord, Chairman	Helena	March 1, 1971
John C. Alley	Helena	March 1, 1973
J. Morley Cooper	Helena	March 1, 1975

Administrative Officials

Vernon B. Miller, Director of Administration and
Secretary of the Board



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STATE OF MONTANA
Office of the Legislative Auditor

STATE CAPITOL
HELENA, MONTANA 59601

The Legislative Audit Committee
of the Montana State Legislature:

This report is presented as a supplement to our report on examination
of the state board of equalization for the fiscal year ended June 30, 1968.

This report concerns the board's compliance procedures and controls
primarily as they relate to administration of the state income tax laws.

We submit the following comments and recommendations for your infor-
mation and for consideration by the board.



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COMMENTS

INCOME TAX

Verification and Audit of Returns

All state income tax returns received are subjected to an initial visual examination--the purpose of which is to determine that the taxpayers have submitted complete information and to select returns for further examination. This visual examination may be conducted by clerical employees or by members of the division's audit staff dependent upon the type of income included in the return. Formal criteria by which the examiners select returns for further examination are limited and leave the more complex areas of tax law to the judgment of the examiners. The personnel making the initial surveys are also responsible for examining the returns further if they are so selected.

The weaknesses we see in this system are:

- (1) If an examiner passes a return which the supervisor feels should have been selected for further review, it becomes a question of the supervisor's judgment versus the examiner's judgment.
- (2) The work load is such that during the processing season examiners might tend to overlook items which deserve further review knowing that the further review would fall back on them.

We believe that a more formal detail set of criteria or guidelines needs to be established for the income tax return examiners to determine which returns should be subjected to further verification. Such guidelines would decrease the amount of reliance that must currently be placed upon the examiners' judgment



and provide a more complete verification program.

Examples of formal criteria which might be established are:

- (1) Casualty losses exceeding \$1,000.
- (2) Gain on installment sale carried over from prior year exceeds \$5,000.
- (3) Questionable dependency exemption.
- (4) Deferred gain on sale of personal residence.

RECOMMENDATION

We recommend that more detailed formal criteria be established as guidelines for the examiners in selecting state income tax returns for further examination.

After completion of the initial visual examination, the returns are sent to the data processing center for mathematical verification. Since detailed information is fed into the computer at this point, it would be possible for the computer to assist in the audit selection process and to serve as an independent means of control over the initial examiners through the establishment of criteria by which the computer would automatically select returns for further examination. Such an extension of the data processing function should also reduce the time required for adequate visual examination.

Examples of such criteria might be:

- (1) Other adjusted gross income deductions exceed \$2,000.
- (2) Total income exceeds \$20,000 and has business or farm income.

RECOMMENDATION

We recommend that criteria which supplement the criteria applied in the visual examination of returns be written into the computer program as an additional means of selecting returns for further examination.



Disposition of those returns which are selected for further examination is accomplished in almost every instance from within the offices of the division, i.e., field offices are not maintained and very little field work is done. Information or records which might be required for the conduct of an audit of a return is solicited either through correspondence or by telephone which often is most difficult from an auditing standpoint. From our auditing experience, we believe that effectiveness is severely impaired by lack of direct contact with the taxpayer and his supporting records. Certainly there are a large number of cases which can be handled without personal contact but many returns are quite complex and require the contact and better access to the taxpayer's records than can be achieved through correspondence.

A great deal of reliance is placed on the federal internal revenue service compliance and enforcement program to perform that same function for the Montana income tax system. Considerable information is received directly from the internal revenue service which is of valuable assistance to the state income tax division. Two prime examples of this are abstracts of revenue agents' reports from which additional Montana income tax is assessed and a magnetic tape of all federal filings received in the Montana district which enables the state income tax division to compare Montana return filings with the federal filings. The purpose of this procedure is to determine those individuals who have not filed state returns and to verify that the amount of adjusted gross income on the federal return is in agreement with Montana adjusted gross income.

Certainly the reliance on the federal program is justified to a considerable extent but it is our opinion that the federal program can be effectively supplemented and complimented through the development of an improved state income tax

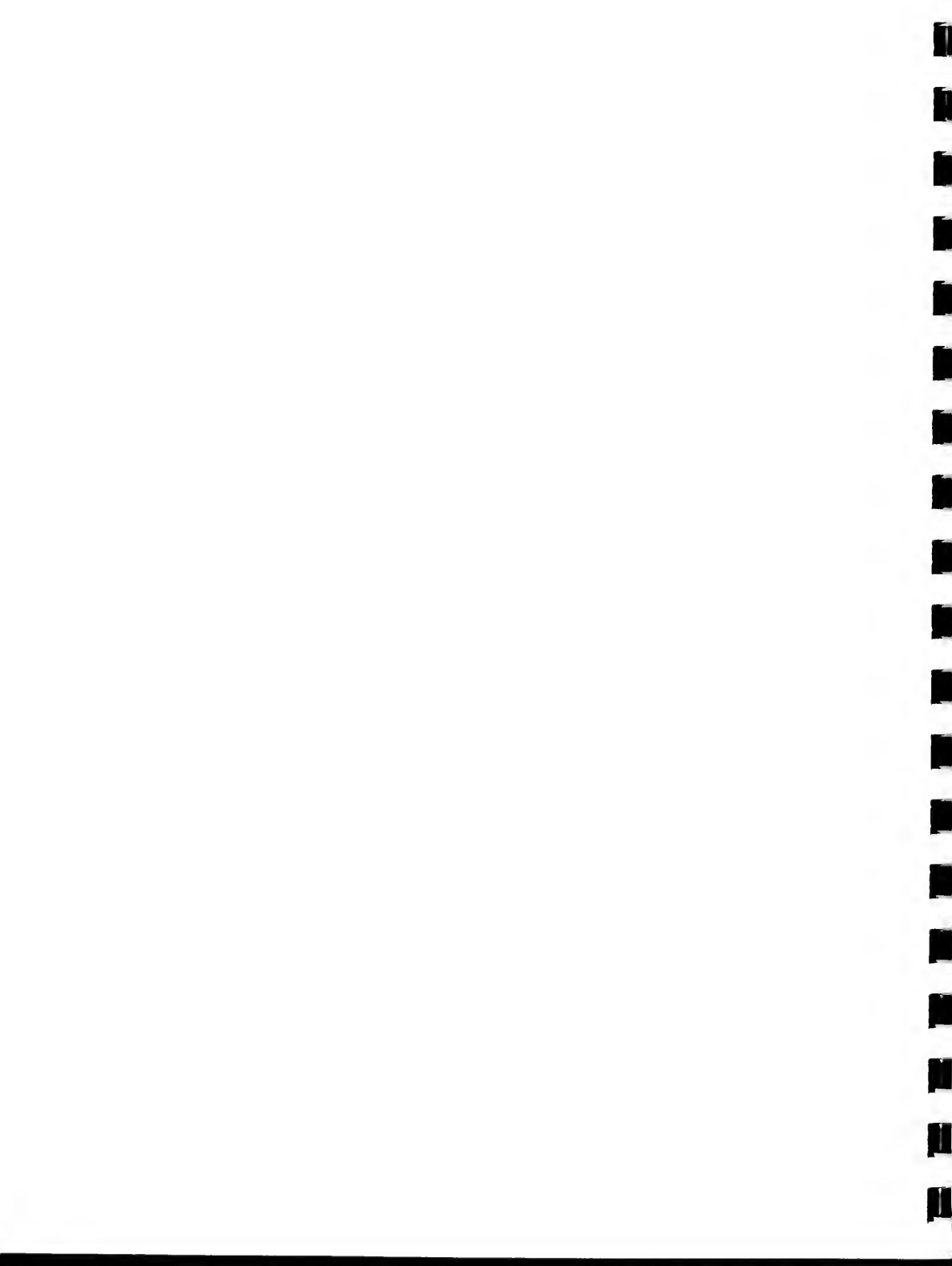


field audit program. Other states, including Oregon and California, have strong field audit systems which recover much more than their operating costs in addition to maintaining a high level of taxpayer compliance with the statutes. The following is a quote from the California franchise tax board in a recent annual report which we believe to be directly applicable to Montana's income tax collection program:

"The administration of a successful self-assessed tax program requires a broad-gauge compliance and enforcement program. Experience has proven that without such a program self-assessed remittances shrink rapidly. While it is essential to watch trends and direct dollar recovery resulting from enforcement and compliance activities, it is vital to be aware of the less measurable impact of these programs on total revenue."

As a part of our examination, a member of our staff visited with the state taxing authorities in Salem, Oregon and received information which serves for comparison purposes although the two systems have different organizational features which might distort personnel comparisons.

- (1) Oregon processes some 750,000 returns with a staff of approximately 500. Montana processes some 270,000 returns with a staff of approximately 50. Roughly, Oregon processes $2 \frac{3}{4}$ times as many returns with 10 times the staff.
- (2) Oregon has a staff of about 135 auditors who perform a substantial amount of field auditing while Montana has a staff of about 14 auditors who do practically no field auditing.
- (3) Oregon has 15 field offices. Montana has none. The Oregon state tax commission's latest biennial report indicates that for the fiscal year



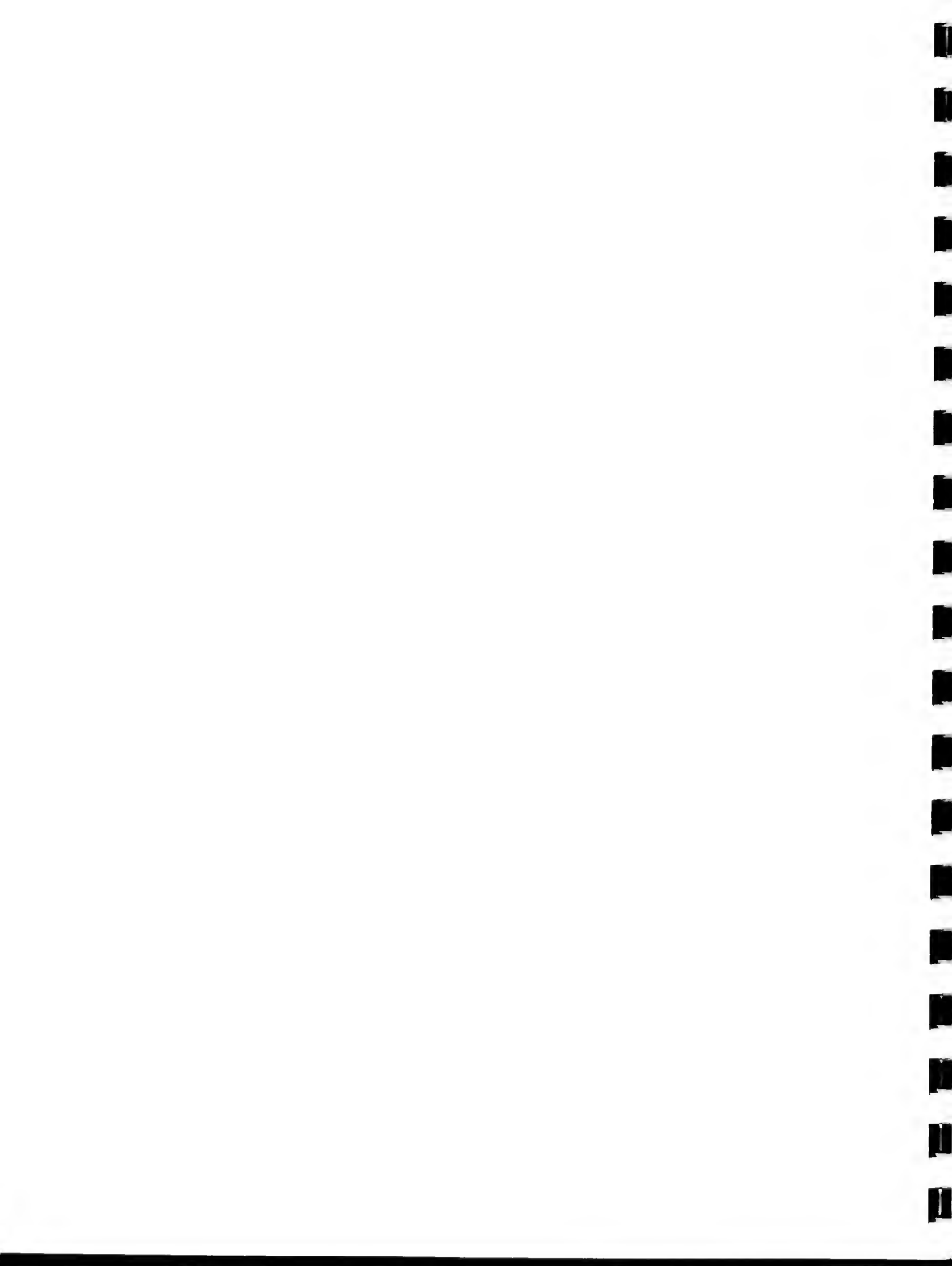
ended June 30, 1968, additional tax assessments resulting from its enforcement and audit program totaled \$8,534,455 (not including penalties and interest). Oregon's tax administrators inform us that for that year the recovery from its field audit program was \$38 per man hour. These amounts might not be applicable to what Montana might realize from such a program because Oregon's tax rates are higher but we believe they indicate a field audit program for Montana would prove to be most beneficial to the state.

RECOMMENDATION

We recommend that a field audit program be initiated on a test basis as a means of verification of proper payment of state income taxes and that adequate records be maintained as a means of determining the results of the program.

It has been the policy of the state board of equalization to expedite the processing of returns on which refunds are due the taxpayers, in which policy we concur. Under the present system, however, if a refund return is selected for further examination, payment is not made until the audit is completed. Refund returns comprise more than 50% of the returns received and all audit time is devoted to refunds until they have been disposed of. We feel that this procedure may be to the detriment of the overall audit program in that:

- (1) Audits of refund returns may be too limited in the attempt to issue refunds on a timely basis.
- (2) Audits of other returns are subordinated to refund audits and, dependent upon the length of time utilized in processing refund returns, the audit staff may have to rush the auditing of other returns in order to complete them prior to the next processing season.



- (3) Audits of other returns may be more productive since the main source of income is usually other than salaries and wages.

The main reason for completing refund audits prior to payment of the refund is to avoid collection problems if a change is made in the tax liability. This is certainly a valid purpose but it may be that the overall income tax program would benefit from the adoption of a post-refund audit system. Such systems are not unusual and the experiences of other states and the internal revenue service could be drawn on for purposes of evaluation.

RECOMMENDATION

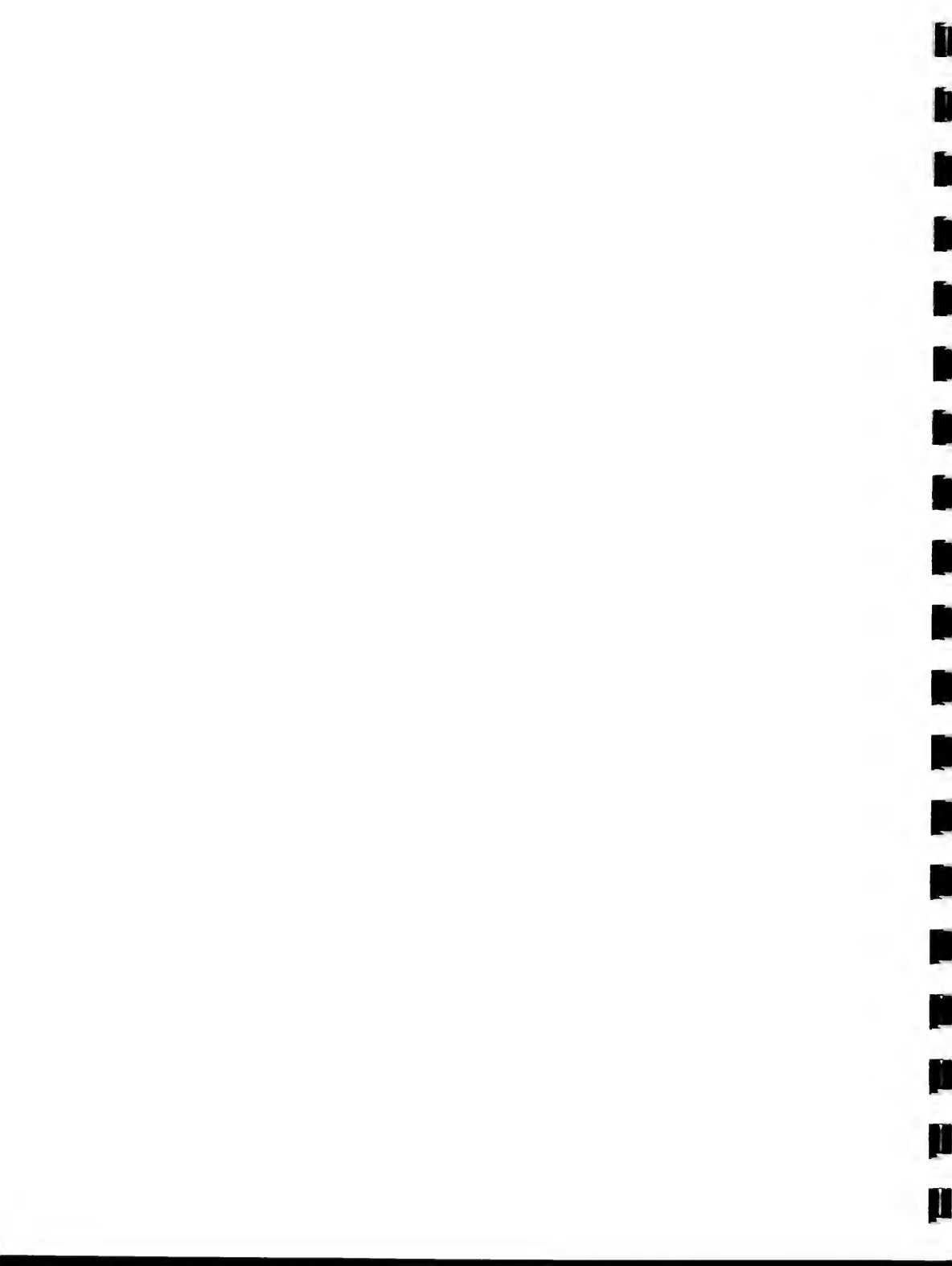
We recommend that the board consider the implementation of a post-refund audit program for income tax on a test basis and maintain records to evaluate the benefits derived from the program.

Withholding

The board's income tax division verification procedures do not provide for a comparison of the amounts of withholding as claimed by individuals on their tax returns to the amounts reported and remitted by employers. Through our sampling procedures, we noted one instance where an employer was issuing wage statements to his employees which denoted withholding but which withholding was not remitted to the board. The employees claimed these withholding amounts as credits on their tax returns and some employees received partial refunds of the withholding. It would also be possible under the present system for taxpayers to file returns with fraudulent wage statements attached for the purpose of receiving refunds. A system that provides for comparison of withholding amounts as reported by employees and employers would eliminate these possibilities.

RECOMMENDATION

We recommend that a system of comparing state income tax withholding amounts



per withholding statements submitted with individual tax returns to withholding statements submitted by employers be implemented, at least on a test basis.

Taxpayer Comparison Files

Two means of determining taxpayer delinquencies and non-filings are presently in use by the board's income tax division:

- (1) The magnetic tape of federal filings in the Montana district are compared to Montana filings and any federal returns for which there are no Montana returns are followed up.
- (2) Cumulative indexes of Montana filings for the last few years are prepared which may then be scrutinized for missing years.

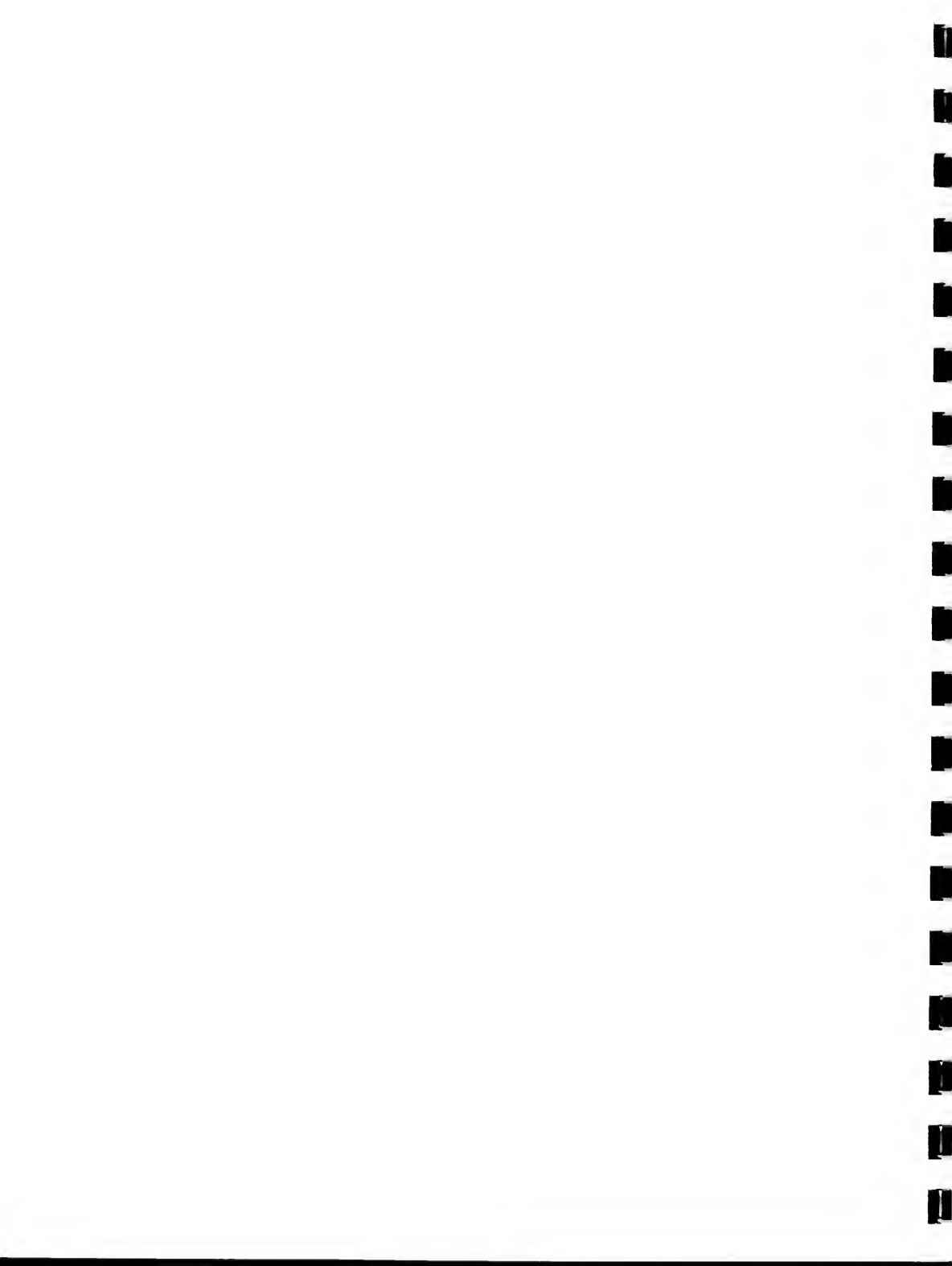
As an extension of the second means, it would be a relatively simple process to have the current year's filings compared with the previous years' filings electronically and have any exceptions listed for disposition. The weakness in the comparison of the federal tape is that taxpayers who did not file federal returns will not be listed since they are not on either tape. The weakness in the cumulative index system is that all taxpayer filings must be scrutinized and working of these indexes is at least two years in arrears.

RECOMMENDATION

We recommend that a data processing program be implemented to compare current year's filings with the previous year's filings as a compliance measure.

Control Over Exceptions Noted on the Comparison of Federal Return Filings to Montana Return Filings

When the comparison of federal return filings to Montana return filings is made, punched cards are prepared by the data processing center for all exceptions noted. These cards are then handled manually and returns are solicited where applicable. Control is not maintained over the cards, however, and there is no



means of determining that all cards were disposed of in the correct manner. The cards could become mislaid, lost or otherwise not brought to the proper conclusion. The data processing center can easily prepare a control printout listing over the exception cards at the time the cards are prepared. This listing would provide supervisory personnel with information as to the disposition of individual cards. The control listings would also be useful for reference purposes in later years.

RECOMMENDATION

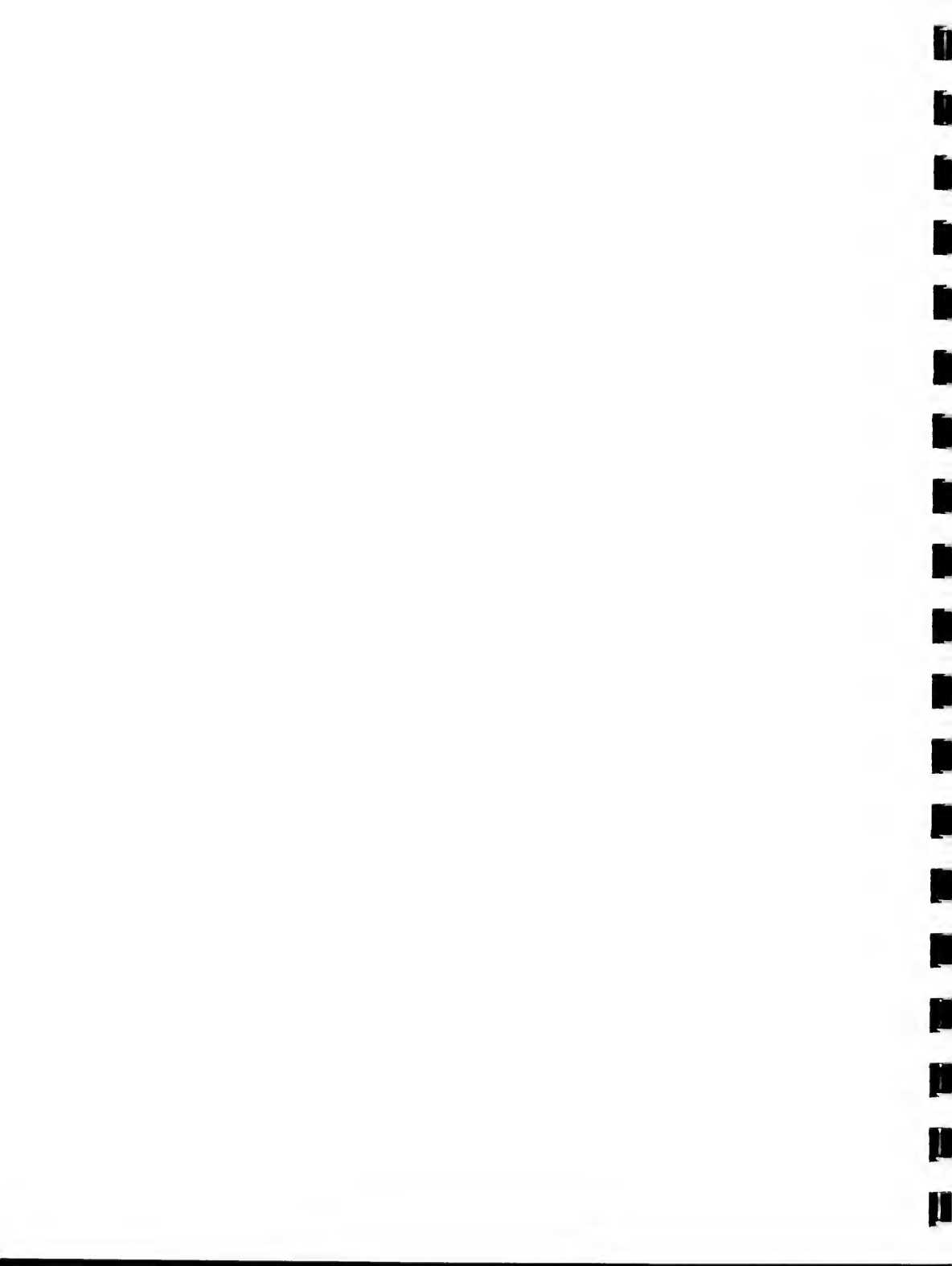
We recommend that a control listing be prepared in conjunction with the preparation of the exception cards when the comparison of federal filings to Montana filings is made and that the final disposition of each exception be indicated on the control listing.

Numbering System

All tax returns showing refunds due are presently being manually numbered twice for reference purposes. Refund returns are assigned temporary numbers when they are sent to data processing for mathematical verification. Permanent numbers corresponding to the warrant number to be issued in payment of the refunds are assigned when the returns have completed processing. It appears that a numbering system could be devised which would eliminate one numbering and still provide a cross-reference to the warrant issued. This would save additional handling of those returns which have not been selected for further examination and save the time required for double numbering all refund returns.

RECOMMENDATION

We recommend that the board evaluate its present system of numbering refund returns to determine if it is feasible to eliminate the necessity of numbering these returns twice.



Data Processing Control Totals

It is presently difficult, if not impossible, to reconcile data processing totals for collections by taxable year to the board cashier's records. The following seem to be at least some of the reasons for disparity:

- (1) Data processing totals are not reconciled to the cashier's batch totals.
- (2) Audit changes on fully paid returns are not reflected in the data processing totals.
- (3) Checks returned by banks for collection may be reflected as receipts twice by data processing.
- (4) Data processing does not create totals on its print-outs which would provide a means for reconciliation, at least on a piecemeal basis.

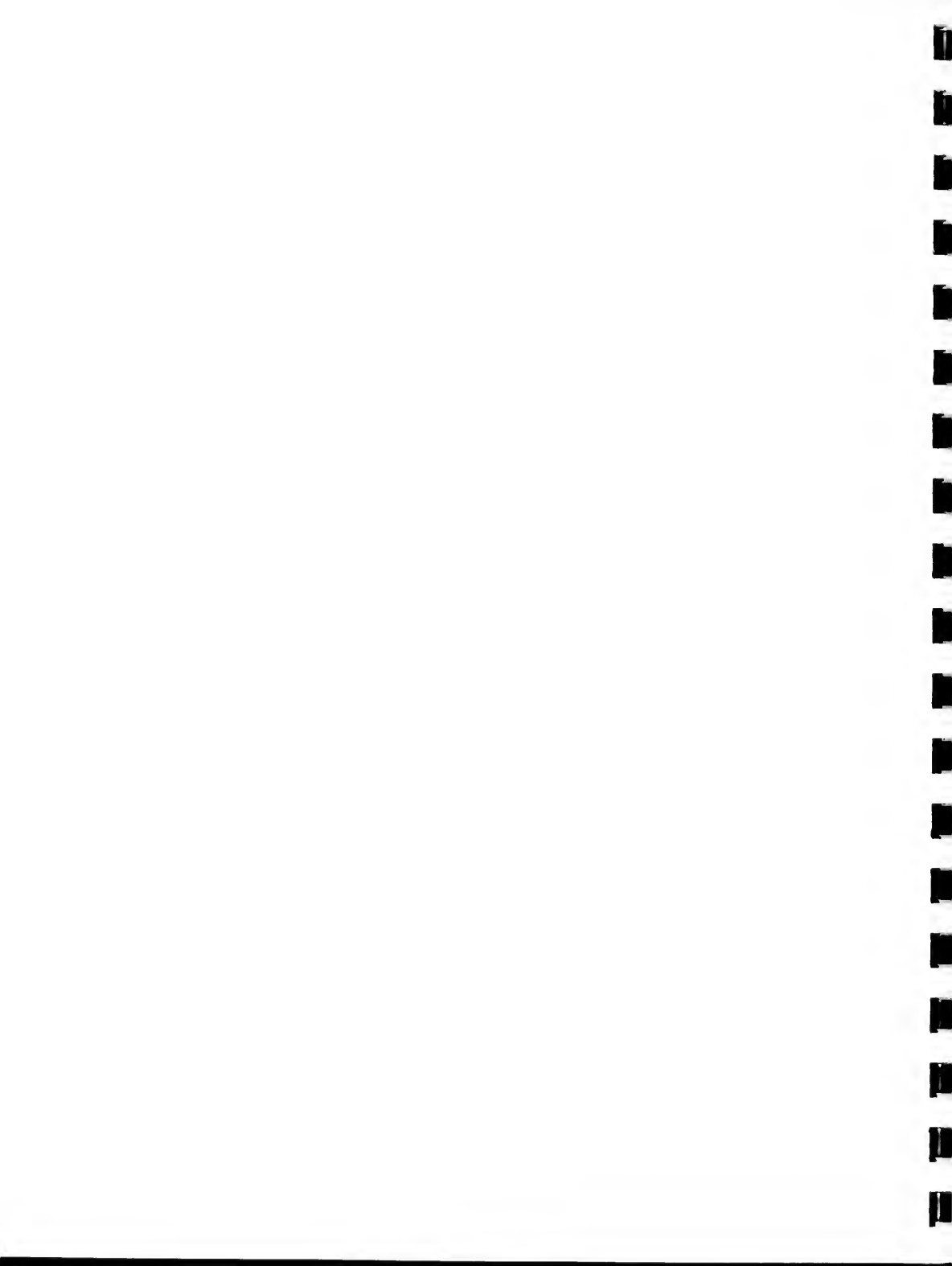
We believe that the increased control and assurance that the data processing listings with which the income tax division works are in agreement with the amounts deposited will justify revising the board's procedures to make this reconciliation a part of its system.

RECOMMENDATION

We recommend that the board establish the necessary procedures to facilitate the reconciliation of data processing totals for income tax collections to the cashier's totals by taxable year and that reconciliations of these totals be made on a periodic basis.

Estimated Tax Payment Requirements

Sections 84-4939-40, R.C.M. 1947, require that individuals whose income from sources other than those subject to withholding tax provisions equals or exceeds the income from sources subject to withholding make declarations of estimated tax and generally provides that such declarations shall be paid in two equal installments on April 15 and October 15 of the taxable year. The statute, however,



does not provide for the assessment of penalty or interest for failure to make and pay such declarations and does not set any percentage requirements as to the amount which should be paid in as a basis for assessing penalty and interest.

Income tax collections are made on the following approximate percentage basis:

Withheld during year	65%
Paid at time of return filing	30%
Estimated during year	<u>5%</u>
	<u>100%</u>

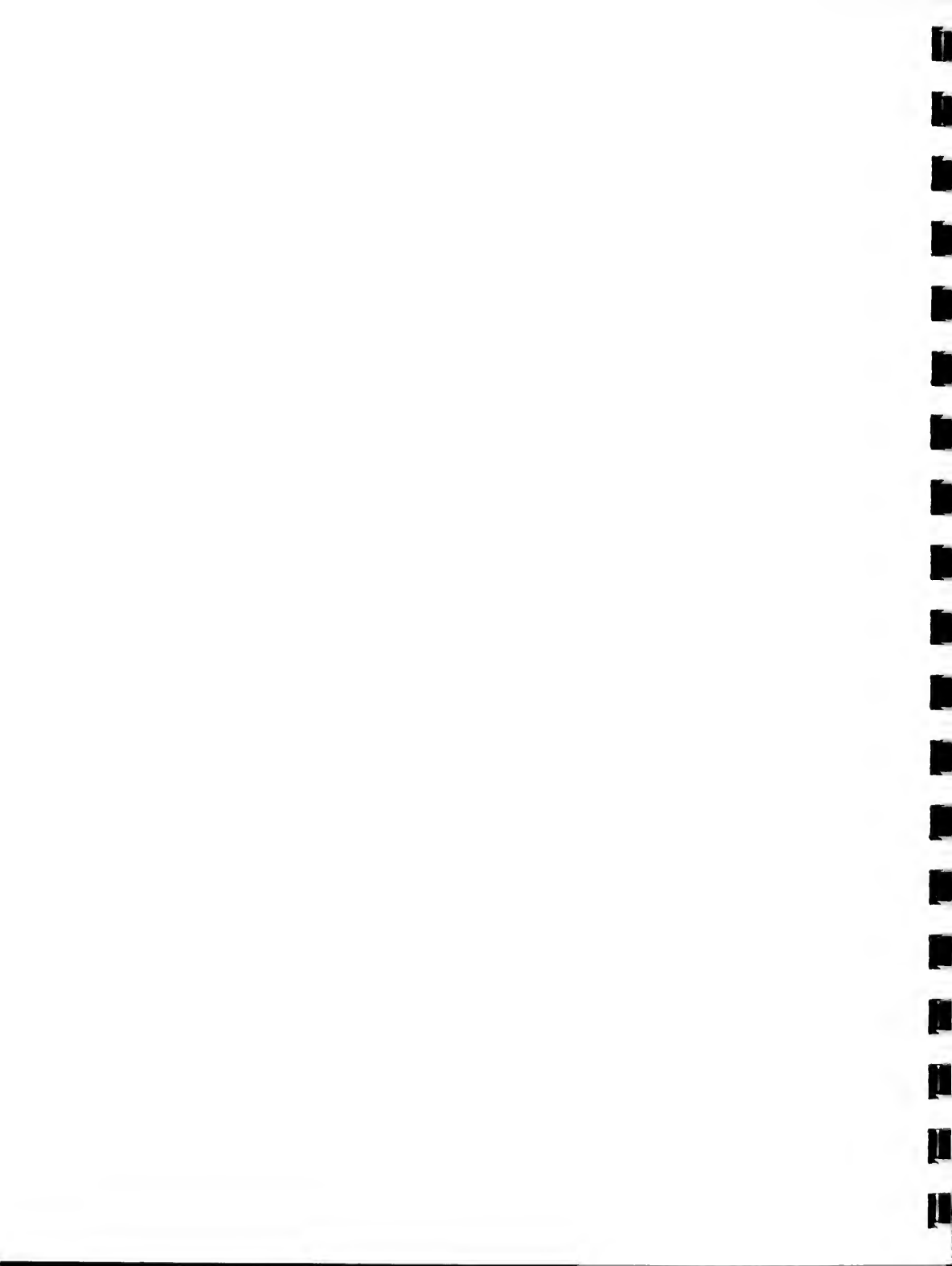
This percentage breakdown indicates that a substantial amount of money which should be received through declarations of estimated tax is not being received until returns are filed. Discussions with tax practitioners indicate that the lack of enforcement provisions is common knowledge.

We believe that passage of legislation establishing enforcement provisions would benefit the state by accelerating the collection of these funds and by reducing collection problems through collection in advance. Conversely, if the estimated tax provisions are not to be enforced, they should be deleted from the law as nuisance provisions.

RECOMMENDATION

We recommend that legislation be enacted to provide for enforcement of the estimated tax provisions and to establish minimum requirements as to the amount of estimated tax to be paid as a basis for assessment of penalties and interest.

Since the present statute does not require declaration and payment of estimated tax unless income from other sources equals or exceeds income from sources subject to withholding, it is probable that substantial amounts of income



are not subject to the estimated tax provisions. A change of this statute to reduce the other income minimum to a lower level would further accelerate revenue and reduce collection problems.

RECOMMENDATION

We recommend that consideration be given to reducing the current minimum income from sources other than those subject to withholding to a lower level for the purpose of determining whether estimated tax payments should be made.

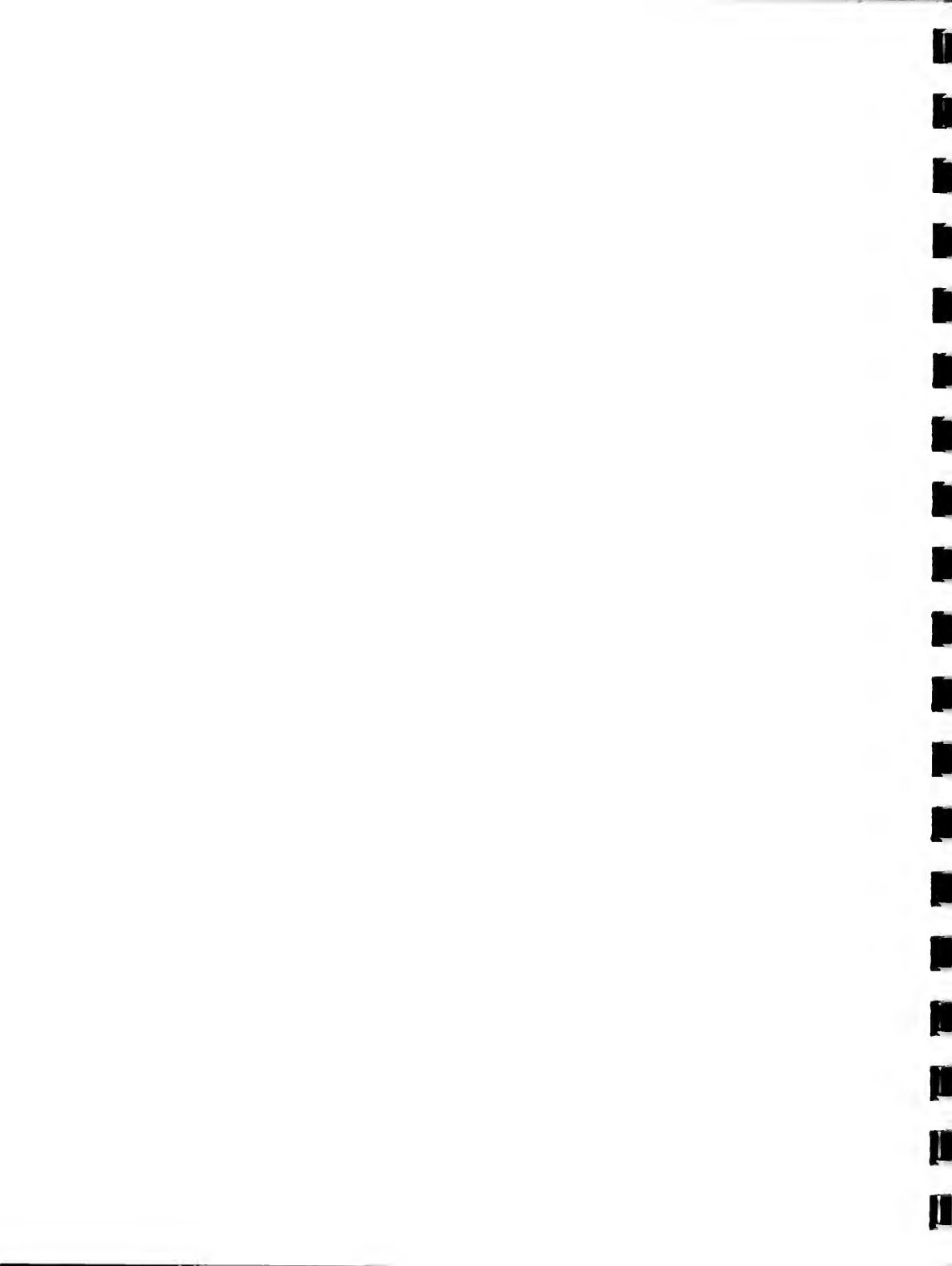
Quarterly Versus Monthly Withholding Remittances

State law section 84-4903.5, R.C.M. 1947, presently requires that employers remit state income tax withholding to the board quarterly. We believe that consideration should be given to requiring these remittances to be made on a monthly basis rather than quarterly, at least when withholdings exceed a certain amount per month. The advantages to the state would be:

- (1) Increased interest income from the investment of the collections.
- (2) Increased revenue of approximately four million dollars in the biennium in which the monthly remittance requirements take effect.
- (3) Reduced losses resulting from employers going out of business without having remitted their employees' withholding. There should be no significant hardship on employers because they are currently required to submit federal withholding on a monthly basis. Because of its simplicity, the added paperwork should create no particular problem for the board except the increase in its volume.

RECOMMENDATION

We recommend that the board evaluate the advantages to the state of requiring monthly employer remittances of employees' state income tax withheld.



"Ideal System"

As discussed in our accompanying report on examination of the board for the fiscal year ended June 30, 1968, we believe it is essential that the board establish a system that will control all its accounts receivable. The volume of paper processed by the income tax division seems to lend itself to automatic data processing methods. There are a number of applications presently in use and we have recommended more in this report. The ideal system, however, would seem to be one involving a total accounts receivable function, i.e., a system whereby all amounts shown due the board from taxpayers would be formally recorded as charges to the individual taxpayer which charges could only be cleared by the crediting of payments, withholding, or action of authorized personnel. Some of the advantages of such a system would be:

- (1) Control over payments, deficiencies and assessments would be facilitated since all revenue would be formally recorded on the accrual basis.
- (2) Accrual basis revenue could be reduced to cash basis revenue for reconciliation to cashiering records and for general accounting purposes.
- (3) It would provide a central information system in which all transactions are formally recorded and as such could provide management with all the financial and statistical information requisite to performance evaluation and decision making.
- (4) It would establish the logical base from which a number of taxpayer compliance functions could be performed, e.g., comparison of employee submitted and employer reported withholding amounts.
- (5) Some clerical functions presently being performed manually could be converted to electronic methods, e.g., deficiency letters and tax changes resulting from mathematical errors.



While the cost of such a system would presumably be high, we believe that the number of control and informational advantages that would be realized warrant consideration and further study.

RECOMMENDATION

We recommend that consideration be given to the establishment of an accounting system involving a "total accounts receivable function" and utilizing more electronic data processing methods.

CORPORATION LICENSE TAX

Field Auditing

No field auditing is performed by the board on corporation license tax returns. The board currently has three employees administering the state corporation tax laws which resulted in over \$7,400,000 collections during 1967-68. We believe the justifications set forth for our recommendations for field audits of individual tax returns are equally applicable to field auditing of corporate taxpayers. In addition, we believe that the need for corporate field auditing is even more critical due to the multi-state activities of many corporations doing business in Montana. Our sampling procedures indicated that a number of these large national firms are filing Montana returns but are paying only the minimum amount tax (\$10 during 1967-68) despite substantial amounts of earnings for their entire operations. Somehow when these companies apportion their earnings among the states in which they operate, Montana operations are determined to be unprofitable. Without an adequate audit staff there has been no means of determining whether or not these apportionments have been made on an equitable basis and in compliance with the applicable statutes.

Hopefully, adoption of the "Multistate Tax Compact" (S.B. No. 5) during the



1969 legislative session will provide some assistance in seeing that proper amounts of income will be apportioned to Montana by the large multistate corporations. The state of Oregon has also adopted this compact but in addition has initiated its own out-of-state audit program, the results of which have been excellent. At printing date of its most recent biennial report, the Oregon state tax commission stated; "To date \$9,668.49 has been spent on these (out-of-state) audits and additional tax has been proposed in the amount of \$361,004.68. This represents a return of \$37.34 on each dollar spent for travel."

We believe that the state of Montana would be favorably benefited by the adoption of its own field audit program and if apportionments among the states are being made on an improper basis, the additional self-assessed revenue which would be gained for future years would certainly be of aid to the state.

RECOMMENDATION

We recommend that a field audit program be initiated for the state corporation license tax program on a basis similar to that recommended for state income tax--basically that the program be launched on a test basis and adequate records maintained to evaluate the benefits derived from the program.

INHERITANCE TAX

Access to Safety Deposit Boxes

Present statutes, section 91-4421, R.C.M. 1947, regulate the access to and removal of contents from safety deposit boxes held in the name of non-resident decedents. We believe that better tax enforcement could be achieved if similar provisions were written into the inheritance tax laws for safety deposit boxes held solely or jointly in the name of a resident decedent.



RECOMMENDATION

We recommend that statutory authority be established that will regulate the right of access to and removal of contents from safety deposit boxes either held solely or jointly in the name of a resident decedent.

Time Limitation on Additional Assessments

The board, since they do not employ their own inheritance tax field audit staff, relies quite heavily for tax compliance on the federal government's field audit program. The federal government furnishes the board with copies of their audit reports. The board based on the information supplied adjusts the amount of the state inheritance tax due. However, the board is not able to fully utilize the results of the federal audits because of a time factor. The board is limited by statute (section 91-4439, R.C.M. 1947) to one year after the court order determining tax has been issued in which to request the assessment of an additional tax. The federal government has three years in which to complete their audits and assess additional taxes. As a result, many of their audit reports are not received in time to permit the board to adjust the state tax due accordingly.

We believe the statutes should be revised in a manner to permit the board to more fully utilize the results of the federal field audit program; especially since the board is required by law (section 84-726, R.C.M. 1947) to refund inheritance taxes claimed as a result of the federal audits for a period up to five years from the date the tax was paid. It only seems reasonable that the state should be permitted, whether it be a tax assessment or a tax refund, to adjust the tax based on the federal audits if the state is to continue to rely basically on the federal audit program for tax compliance.

RECOMMENDATION

We recommend that the inheritance tax laws be revised to permit the state to more fully utilize the federal field audit program.



CONCLUSION

We have reviewed the recommendations contained in this report with the board's division heads, the director of administration, and the board members.

The cooperation and assistance provided to us by the board members and the board's employees is sincerely appreciated.

Respectfully submitted,

Morris L. Brusett

Morris L. Brusett
Legislative Auditor

July 1, 1969



